Interim Economic Assessment

3 September 2013

A moderate recovery in the advanced economies, but global growth is sluggish and risks remain

The pace of recovery in the major advanced economies improved in the second quarter and growth is expected to be maintained at a similar rate in the second half of the year. Activity is expanding at encouraging rates in North America, Japan and the United Kingdom, while the euro area as a whole is no longer in recession.

In several major emerging economies, however, growth has slowed. While growth in China appears to have passed the trough, financial market turbulence - partly triggered by discussion of a tapering of quantitative easing in the United States - has highlighted difficulties facing a number of other emerging economies, especially those with large current account deficits. As emerging economies contributed strongly to economic dynamism in recent years, this slowdown makes for a continuation of sluggish global growth, notwithstanding the pick-up in advanced economies.

While the improvement in growth momentum in OECD economies is welcome, a sustainable recovery is not yet firmly established and important risks remain. It is necessary to continue to support demand, including through unconventional monetary policies, in order to minimise the risk of the recovery being derailed. Meanwhile, both advanced and emerging economies face the challenge of slower trend growth. Therefore, reforms to boost growth, rebalance the global economy and reduce structural impediments to job creation remain vital.

Indicator-based forecasts for GDP growth in the major economies[1]

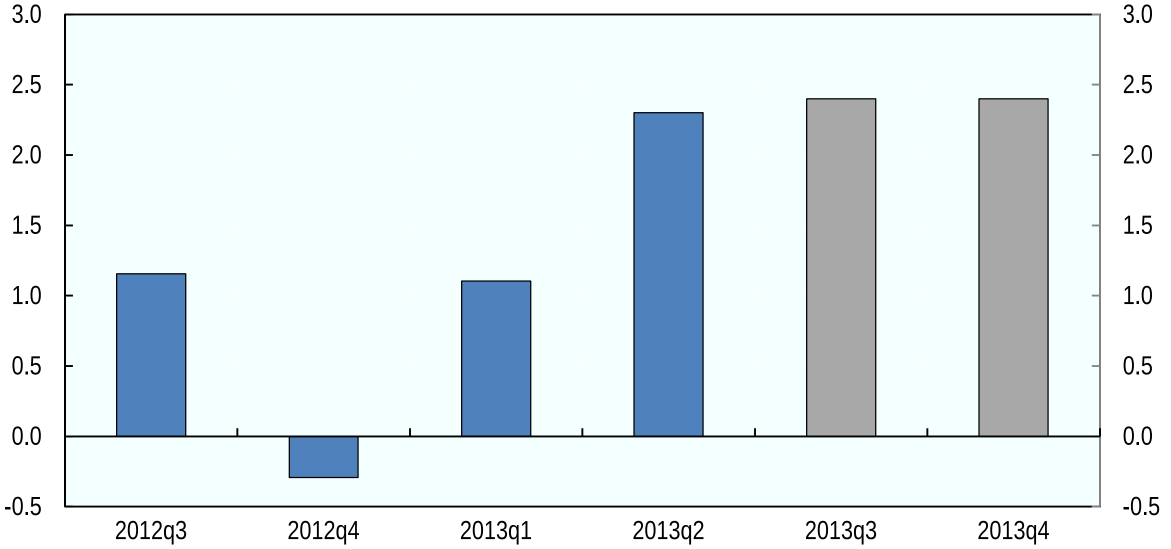
	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4	2012	Implied 2013[2]
	(Annualised quarter-on-quarter percentage change)					*(Average annual percentage change)*	
United States	0.1	1.1	2.5	2.5	2.7	2.8	1.7
China	7.8	6.6	7.0	7.2	8.1	7.8	7.4
Japan	1.0	3.8	2.6	2.6	2.4	2.0	1.6
Germany	-1.8	0.0	2.9	2.3	2.4	0.9	0.7
France	-0.7	-0.6	1.9	1.4	1.6	0.0	0.3
Italy	-3.7	-2.2	-1.0	-0.4	-0.3	-2.4	-1.8
3 largest euro area countries[3]	-2.0	-0.8	1.6	1.3	1.4	-0.2	-0.1
UK	-0.9	1.1	2.9	3.7	3.2	0.2	1.5
Canada[4]	0.9	2.2	1.7	(4.8)	(2.5)	1.7	2.0

1. Based on GDP releases and high-frequency indicators published by 2 September; seasonally and in some cases working-day adjusted.
2. Annual growth numbers for 2013 are derived by applying the indicator model forecasts for the third and fourth quarters to the outcome for the first two quarters. See Appendix for underpinnings and status of the interim forecast.
3. Weighted average of Germany, France and Italy.
4. The indicator model forecasts for Q3 and Q4 2013 have been adjusted for the impact of the floods in Alberta and strikes in Quebec in June, based in part on estimates in the Bank of Canada's July Monetary Policy Report.
Source: OECD Interim Forecast.

In the major advanced economies, a moderate recovery is set to continue

- Growth in the second quarter in the major advanced economies as a whole was stronger than forecast. The United States continued to recover, despite headwinds from sharp fiscal consolidation, and the Japanese economy rebounded in the first half of the year under more expansionary policies. Euro area GDP in the second quarter bounced back from a period of exceptional weakness in late 2012 and the first quarter of 2013, ending six quarters of contraction, although several countries remained in recession. In the United Kingdom, growth picked up momentum through the first half of the year.
- Based on recent indicators, growth for the major advanced economies as a whole in the second half of 2013 is forecast to continue at the improved rate seen in the second quarter.

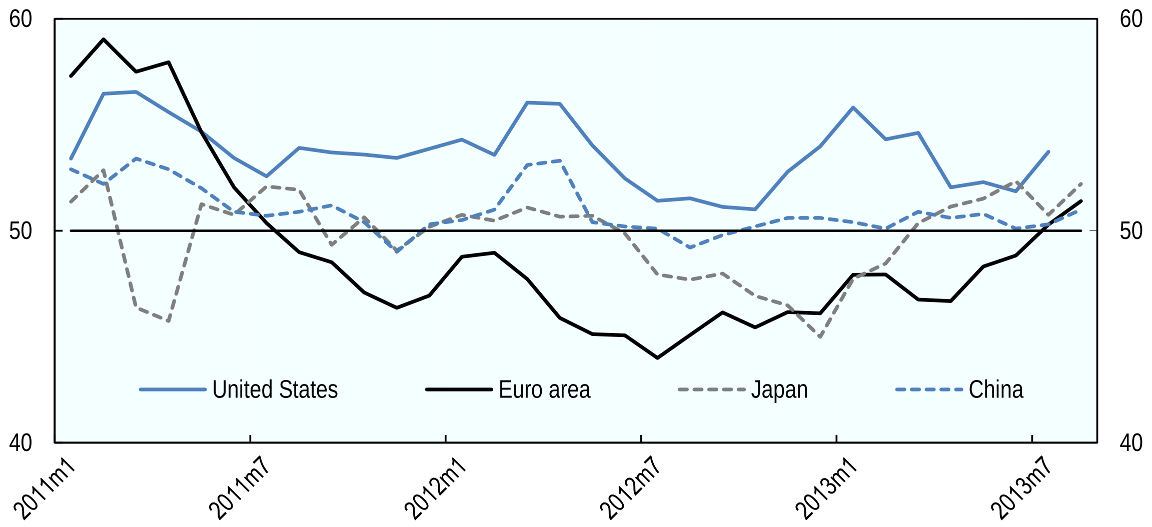
G7 real GDP growth
Quarter-on-quarter percentage change, seasonally adjusted annualised rate



Source: OECD Main Economic Indicators; OECD indicator-based forecast.

- The pick-up in business confidence and industrial production in recent months in many advanced economies is consistent with the recent and projected strengthening of momentum. The US housing market has gained strength, although higher bond yields may moderate the recovery. Consumer confidence has strengthened to healthy levels in Japan, but remains low in the euro area despite recent improvements.

Manufacturing PMI indicators
Index level[1]

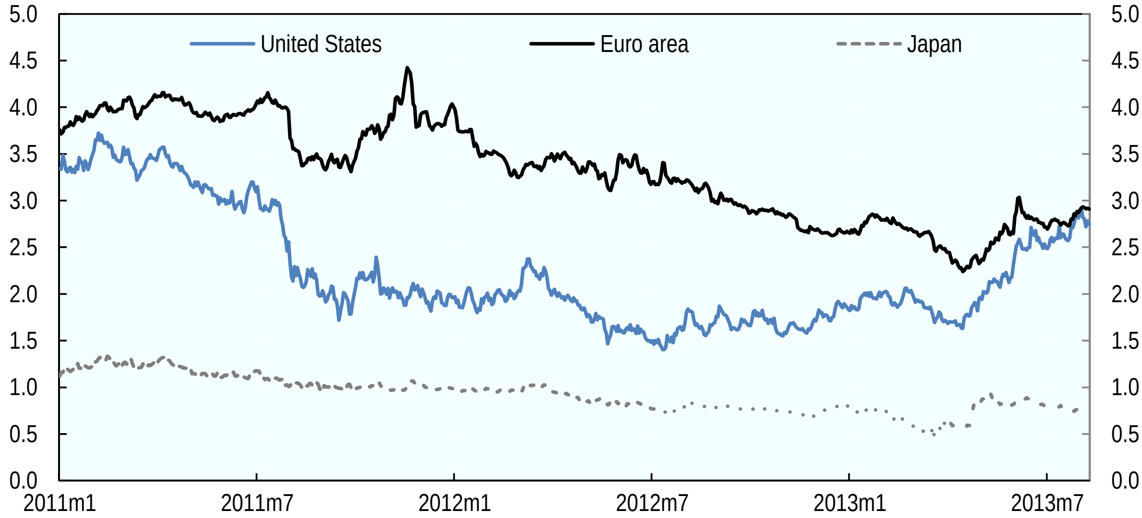


1. Levels above 50 indicate expansion.
Source: Markit Economics Limited; National Bureau of Statistics, China.

Global financial conditions have tightened, creating difficulties for some emerging economies

- A tightening of financial conditions has taken place across much of the global economy in recent months. Long-term interest rates have risen since May, triggered by discussions concerning the prospective withdrawal of additional quantitative easing measures in the United States in the light of growing evidence of a strengthening US economy. The extent of financial asset price movements has reflected changing market assessments of growth prospects across countries as well as central bank responses, with, in particular, the European Central Bank's forward guidance helping to cushion euro area bond markets. Overall, although financial conditions have tightened to some degree in most markets, they remain strongly supportive of recovery in advanced economies.

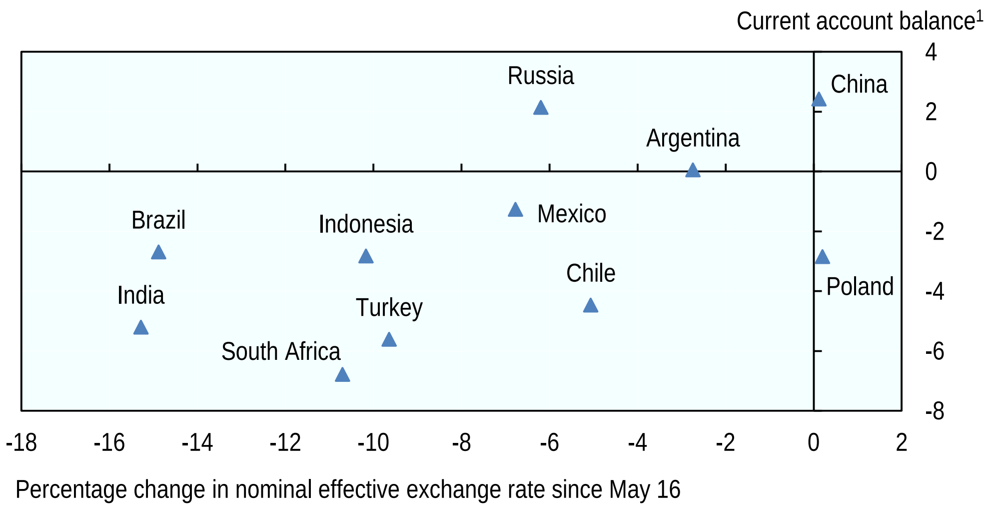
Benchmark 10-year government bond yields
Per cent



Source: Datastream and Eurostat.

- In many emerging economies, however, loss of domestic activity momentum together with the shift in expectations about the course of monetary policy in the United States and the ensuing rise in global bond yields have led to significant market instability, rising financing costs, capital outflows and currency depreciations. Countries that have relied heavily on portfolio inflows to finance large current account deficits have been most affected.

Recent exchange rate movements and current account balances among emerging economies



1. Trailing 4 quarters, in per cent of GDP.
Source: Datastream; OECD Economic Outlook 93 database.

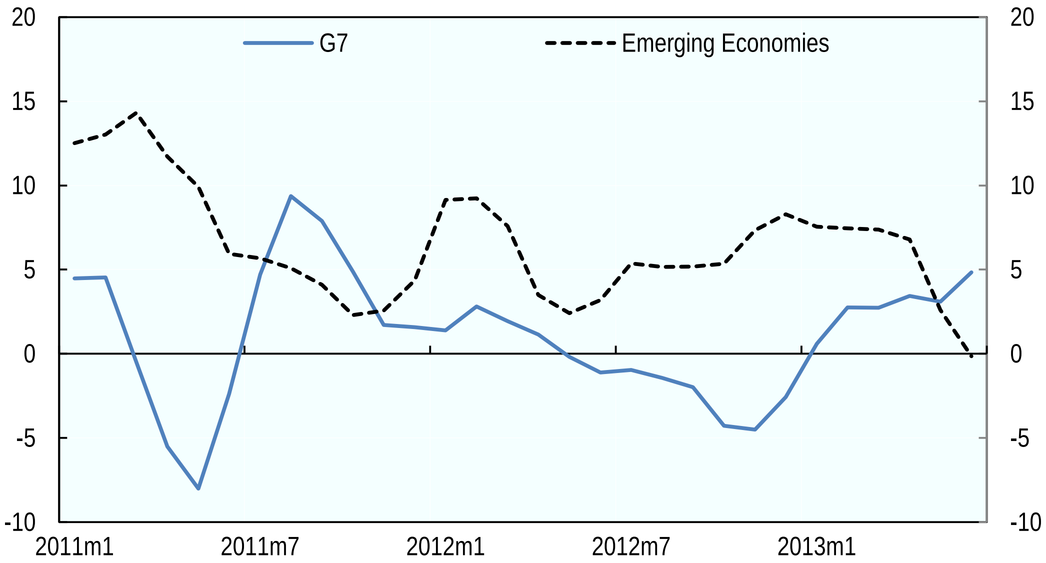
- These recent developments represent a reversal of the pattern prevailing for the past few years, when weak activity and expansionary monetary policy in advanced countries led to strong capital inflows and currency appreciation in emerging economies, where economic growth was strong.

Growth has slowed in major emerging economies

- Growth prospects in this new situation vary across emerging economies. Growth in China has seemingly already passed the trough and looks set to recover further in the second half of 2013, although the expansion is still expected to be more subdued than in earlier cycles.
- However, in a number of other emerging economies the recent financial market tensions and weak momentum suggest both a reappraisal of trend growth and deterioration in cyclical conditions. For the BRIICS countries as a group, annual trend growth may have declined by more than 1 percentage point over the past five years. This reflects demographic factors to some degree, but also some waning of underlying productivity growth, which can in part be traced to declining momentum of structural reform.

Industrial production

Annualised 3-month-on-3-month percentage change



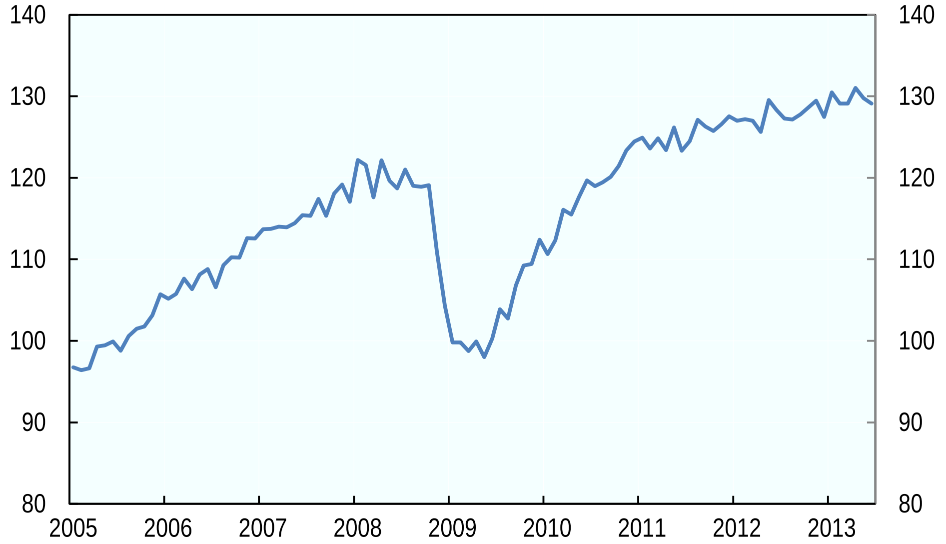
1. The series are seasonally and working-day adjusted.

Note: The values for Emerging Economies are a weighted average of those for Brazil, China, India, Indonesia, the Russian Federation and South Africa, where weights are nominal GDP, measured at PPP 2005 USD.

Source: OECD Economic Outlook 93 database; OECD Main Economic Indicators database; national statistical agencies; and OECD calculations.

- The growing trade linkages with and between emerging economies mean that the demand slowdown in these economies is contributing to the continued weakness of the global trade recovery.

World merchandise trade
Index, 2005 = 100



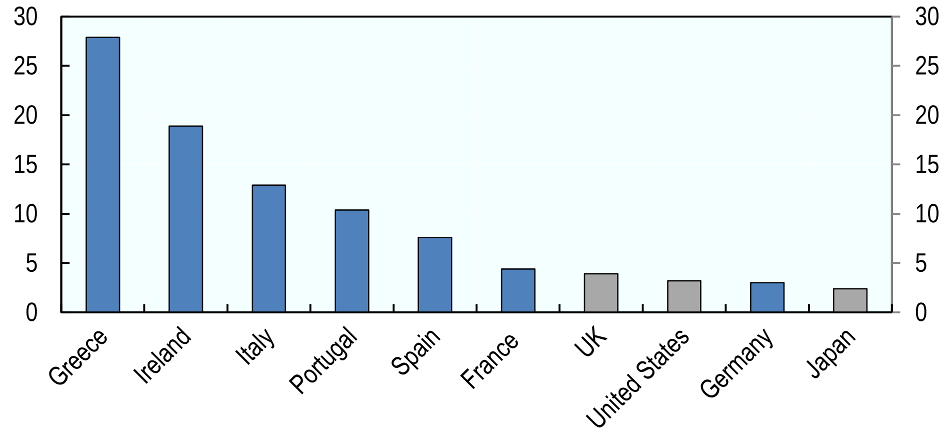
Source: CPB.

- As emerging economies contributed the bulk of global economic growth in recent years, and since their share of global output has increased so much, this widespread loss of momentum makes for sluggish near-term growth prospects for the world economy.

Risks remain high

- The euro area remains vulnerable to renewed financial, banking and sovereign debt tensions. Many euro area banks are insufficiently capitalised and weighed down by bad loans. Recent progress towards a common supervision and new resolution arrangements will help, but measures are required to ensure the credibility of next year's asset quality review and bank stress tests and to provide adequate financial support arrangements to meet shortfalls in bank capital.

Non-performing loans
Per cent of total



Note: End-2012 for Greece, Ireland, Portugal, Spain and the United States; end-September 2012 for Japan; end-June 2012 for France and Italy; and end-2011 for Germany and the United Kingdom. Euro area countries shown in blue, other countries in grey. Cross-country comparisons of NPLs are complicated by differences in definitions.

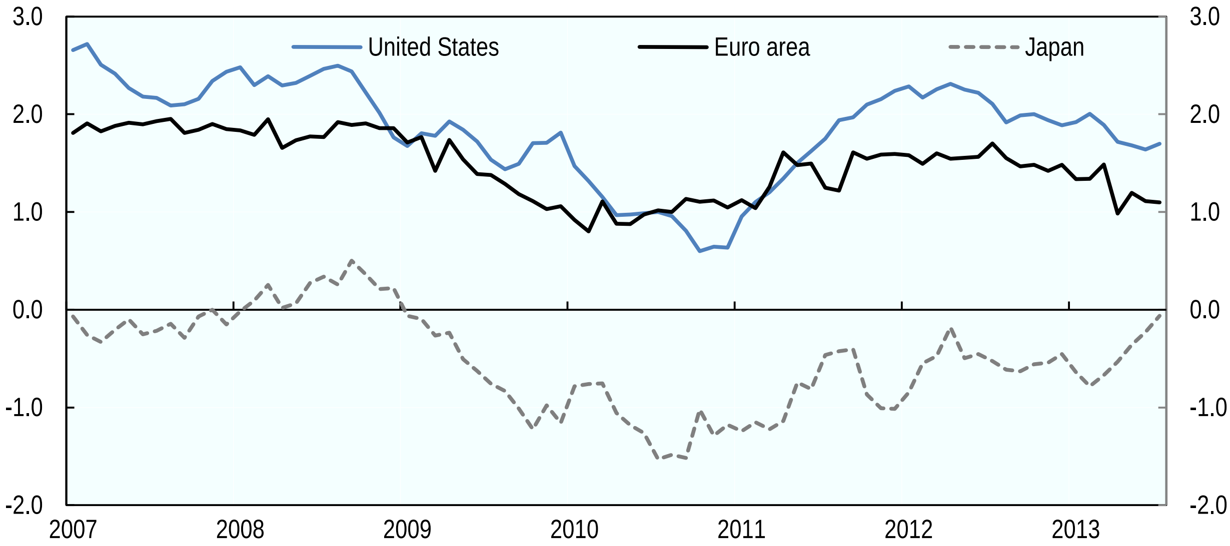
Source: IMF Financial Soundness Indicators.

- There is a risk that the financial market volatility and strong capital outflows in recent months in some emerging economies could intensify, exerting an additional drag on growth. High levels of debt built up during recent years increase the vulnerability to financial shocks.
- A repeat of earlier episodes of deadlock and brinksmanship over fiscal policy in the United States has the potential for serious negative economic consequences. Failure to reach agreement on a timely basis on raising the federal government's debt ceiling, which would be reached in October, or on an appropriation for 2014 or a continuing resolution, could lead to disruptions in government spending and trigger adverse reactions in financial markets or weaken confidence.

Macroeconomic policy should continue to support demand

- Monetary policy remains key to supporting demand in advanced economies, although differences in progress towards recovery warrant differentiation in policy settings. Unemployment is high and underlying inflationary pressures are weak. Core inflation is generally running below official medium-term inflation objectives. Hence, considerable monetary policy support should remain in place.

Core inflation
12-month percentage change in core price index



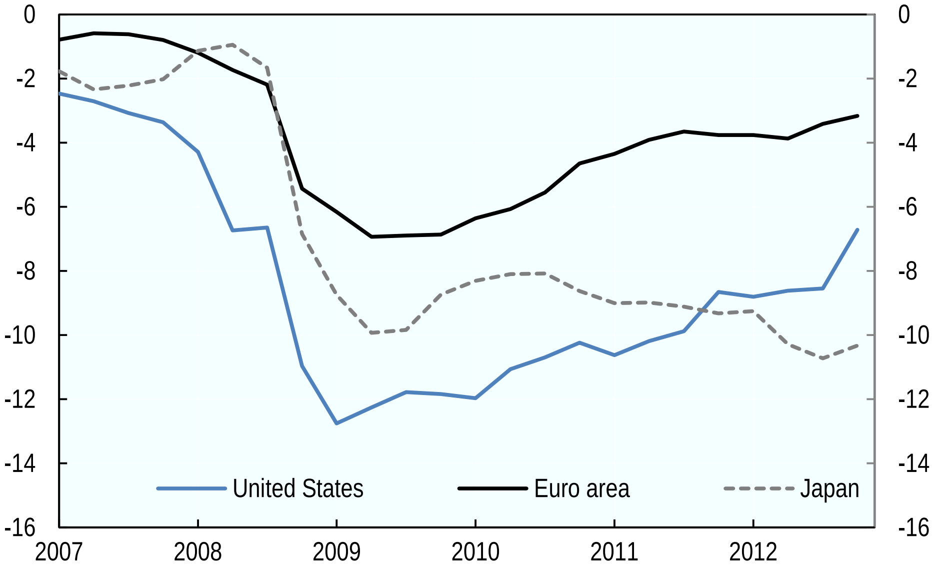
Note: For the United States and Japan, core price index is CPI excluding energy and food, for the euro area, HICP excluding food, energy, alcohol and tobacco. The last observation is July.

Source: OECD Main Economic Indicators database; OECD calculations

- In the United States, it would be appropriate for the Federal Reserve gradually to reduce the rate of bond purchases, while continuing to keep policy interest rates low for some time in line with existing forward guidance.
- Monetary easing in Japan should continue until the new 2% inflation target has been sustainably achieved.
- In the euro area, supportive monetary conditions must be maintained, while scope for further monetary easing remains if the recovery were to fail to take hold. Additional measures may also be needed to address impaired monetary transmission, such as by providing direct incentives to banks to extend credit to the real economy.

- In China, while subdued inflationary pressures create room for monetary easing if growth were to flag, the strong growth of credit to date suggests the need for caution.
- Difficult policy dilemmas are likely to persist in many other emerging economies. Pressures for currency depreciation and capital outflows may militate in favour of raising interest rates, while cyclical conditions may suggest easing. Countries that have had currency appreciation and large current account deficits during the last few years should generally not resist downward pressure on their currencies in the new environment, although they will have to weigh the risk of rapid depreciation feeding an inflationary spiral, sapping confidence and/or having adverse balance sheet effects owing to currency mismatches in some parts of the economy.
- The fiscal situation has improved in the major advanced countries, with the exception of Japan, but fiscal consolidation remains necessary. In the United States, a credible medium-term fiscal plan needs to be set out. In the euro area, existing fiscal plans should be implemented and the automatic stabilisers allowed to operate fully. In Japan, the consumption tax should be increased in 2014 as planned, but temporary fiscal measures could be envisaged to limit the near-term growth impact.
- Against the background of a need for further consolidation, it remains vital to maintain public support and to protect the most vulnerable groups. Consolidation packages should be better designed, including by prioritising spending to help people get back to work and mitigate inequality.

General government balance
Per cent of GDP



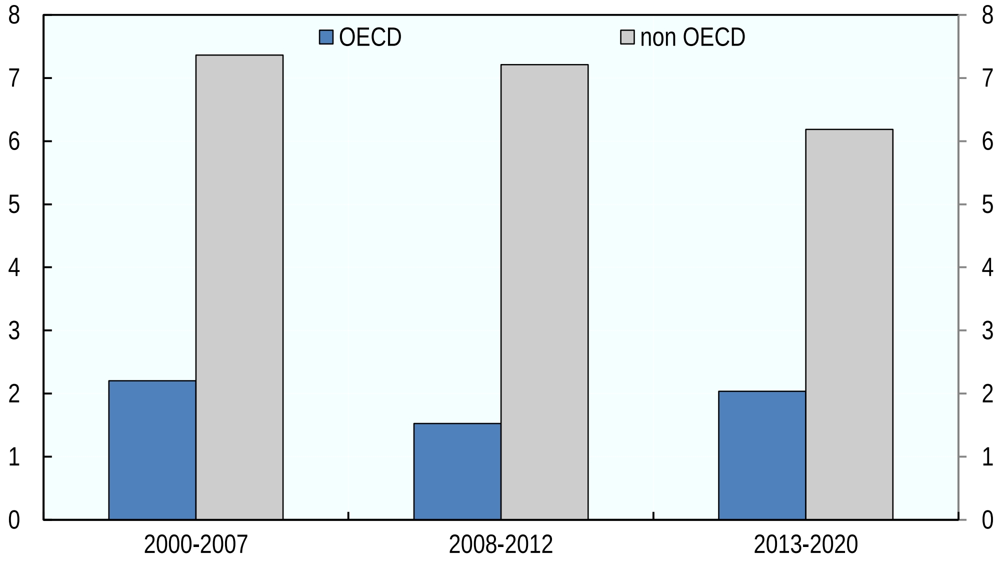
Source: Economic Outlook 93 database.

- Efforts to strengthen financial regulation should continue. Bank balance sheets should be thoroughly cleaned up to create the conditions for new lending. Regulatory reforms should now focus more on bank business models and avoiding excess leverage, notably through the separation of investment banking activities from traditional commercial banking businesses.

Reforms to create jobs, boost growth and rebalance economies are needed

- Weak employment, sluggish global growth and lingering global imbalances underline the need for structural policies - in addition to those to support demand – to create jobs, raise growth, ease fiscal pressures and permanently reduce external imbalances. In many advanced and emerging economies, growth is likely to remain below pre-crisis trends, reflecting both structural changes such as demographics and the consequences of the crisis itself.

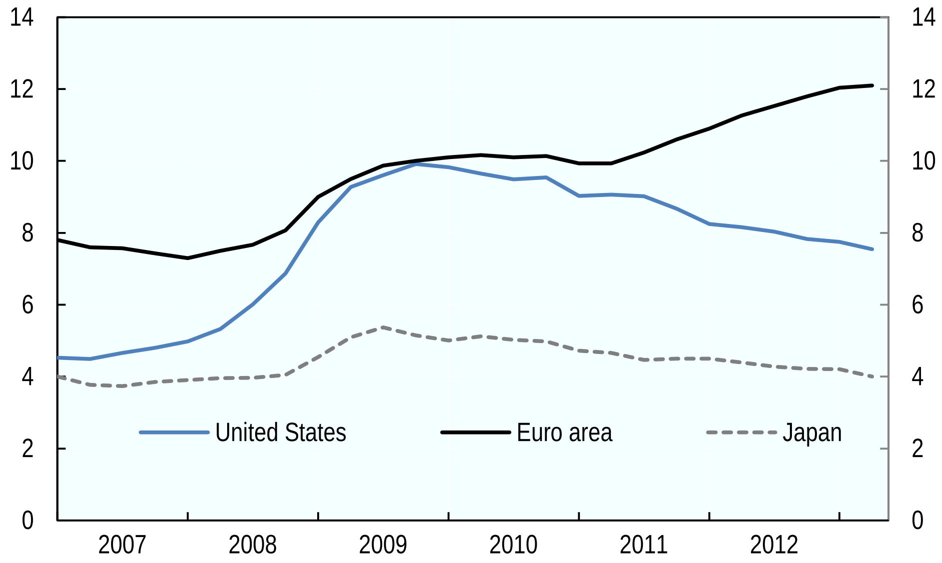
Growth of potential output
Average annual percentage change



Source: OECD Economic Outlook 93 long-term database.

- Unemployment remains high in many advanced economies, despite some improvement in the United States and Japan. Long periods of high unemployment may lead to rising structural unemployment, which will remain even as the recovery takes hold.

Unemployment rate
Per cent of the labour force

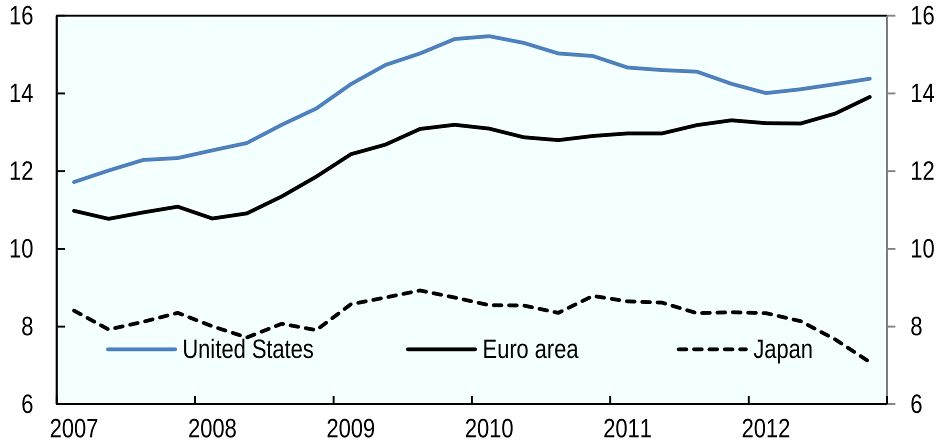


Source: OECD National Accounts database; Eurostat.

- More effective activation and training policies, supported by stronger demand, would help to tackle high long-term unemployment and longstanding low employment rates, alongside reforms to tax-benefit systems to improve work incentives. Targeted measures are needed for some groups, such as the increasing number of young people not in employment, education or training (NEET). In many emerging economies, widespread informality in the labour market needs to be tackled.

Youth inactivity

Percentage of population aged 15-24 not in employment, education or training

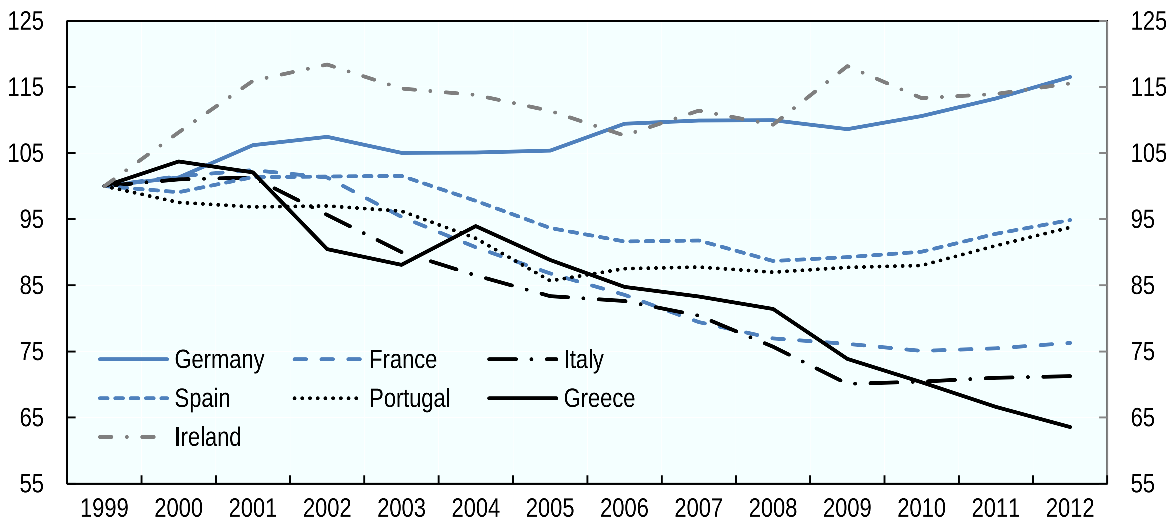


Note: The series are seasonally adjusted. The most recent observation is 2012 Q4.
Source: OECD calculations based on the OECD Short-term Labour Market Statistics Database and national labour force surveys.

- In the euro area, rebalancing remains incomplete with weak domestic demand in high debt countries having been offset by stronger exports only to a limited extent. Reforms to enhance productivity, such as easing restrictions in product markets and making labour markets more dynamic, will help to improve underlying competitiveness and export performance. At the same time, measures to create more favourable conditions for investment in the surplus economies would help to achieve more balanced growth in the euro area as a whole.

Export market performance

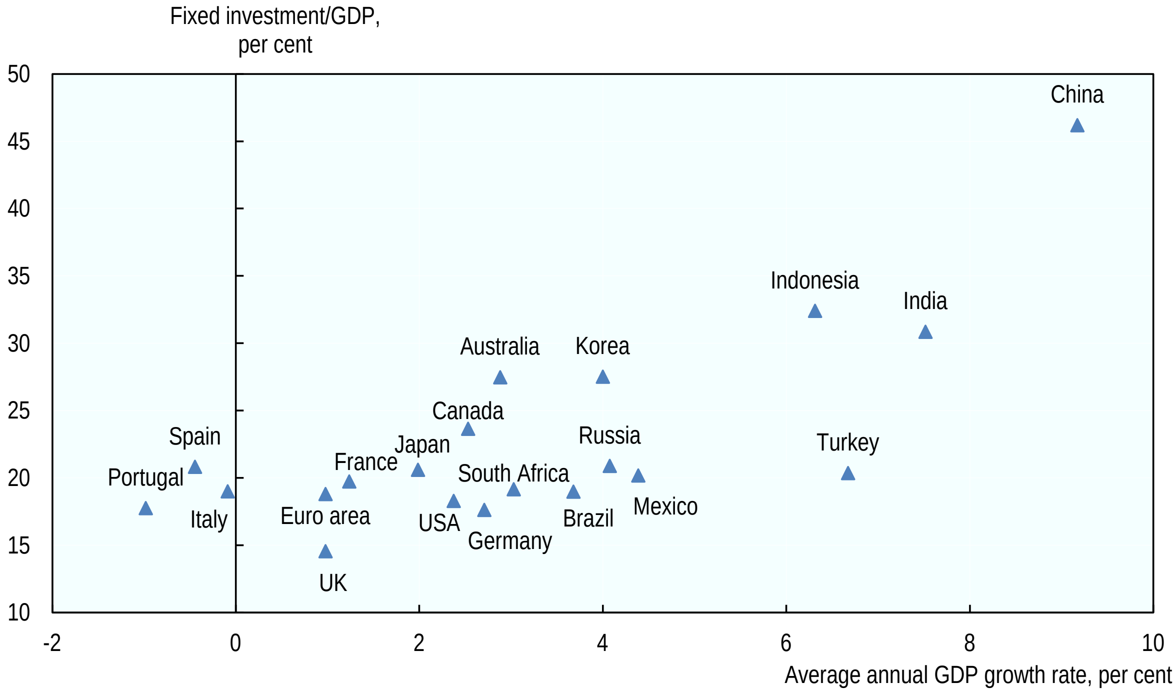
Index 1999=100



Source: OECD Economic Outlook 93 database.

- Structural reforms will help China make the necessary rebalancing away from very heavy reliance on investment towards a pattern of demand that is more sustainable for an economy with a lower trend growth rate and without leading to a renewed rise in current account imbalances. These reform measures include the on-going development of social safety nets to reduce excess saving and removing obstacles to the development of the services sector.

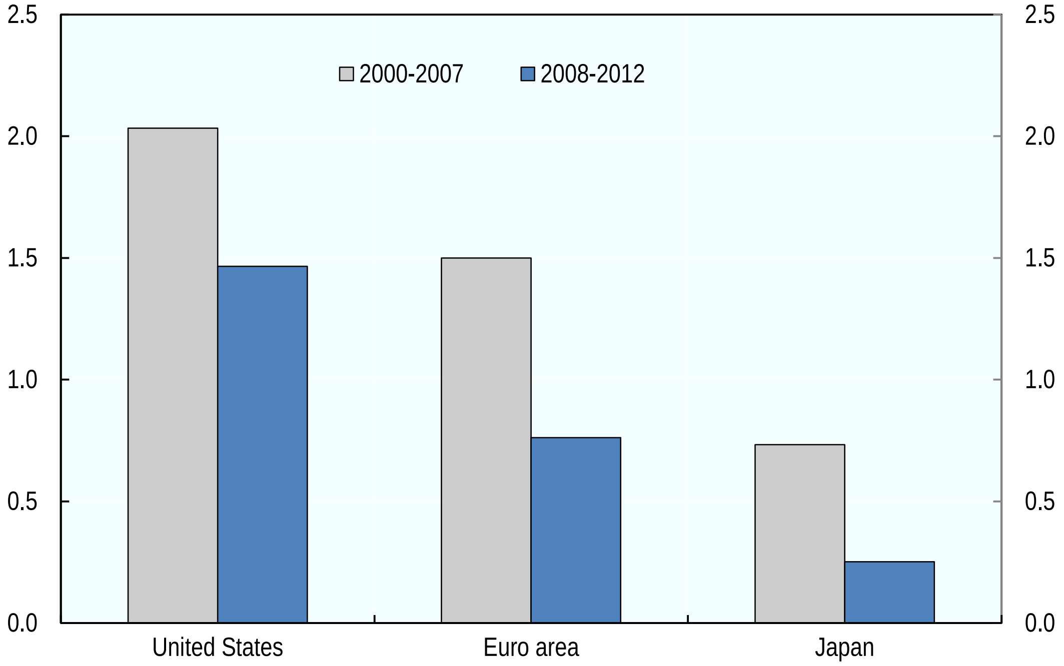
Investment-to-GDP ratio and GDP growth, 2010-2012



Source: OECD national accounts database; Datastream.

- Persistently weak investment in advanced economies since the crisis has slowed the growth of capital and risks holding back productivity growth during the recovery, while low investment continues to drag on demand. Repair of the financial system and regulatory reforms to improve incentives for lending to business would help to unlock private investment during the recovery.
- Greater progress towards removing obstacles to trade would help to boost productivity growth and give a new impetus to flagging growth of trade volumes. This requires progress on bilateral and regional free trade agreements alongside multilateral discussions. Reforms to remove restrictive product market regulations and greater efforts at trade facilitation would reinforce such agreements.

Productive capital stock
Average annual growth rate, per cent



Source: Economic Outlook 93 database; OECD calculations.

- High unemployment and slow growth are likely to add to social tensions in advanced and emerging economies. This highlights the need for macroeconomic policy to provide sufficient support for demand while necessary reforms are undertaken. Institutional reforms can also directly tackle inequalities, such as by improving access to education and improving the targeting of transfers to those who need them most.

- It is encouraging that countries in crisis have stepped up the pace of structural reform in recent years. However, reform efforts have been only moderate in many other countries, including some advanced economies and emerging economies that benefitted from positive capital inflows. The slow pace of reform has hindered the needed rebalancing of the global economy and complacency has left some countries unduly exposed to low growth and financial tensions.

Appendix

Status and underpinnings of the Indicator-based Forecasts

The Indicator-based Forecasts in this assessment do not represent a full update of the biannual *Economic Outlook* projections. The Interim Forecasts cover only GDP over a short horizon for a small number of countries, and rest on more limited information set than the *Economic Outlook*. However, the Interim Forecasts help evaluate the extent to which the latest *Economic Outlook* projections are still on track.

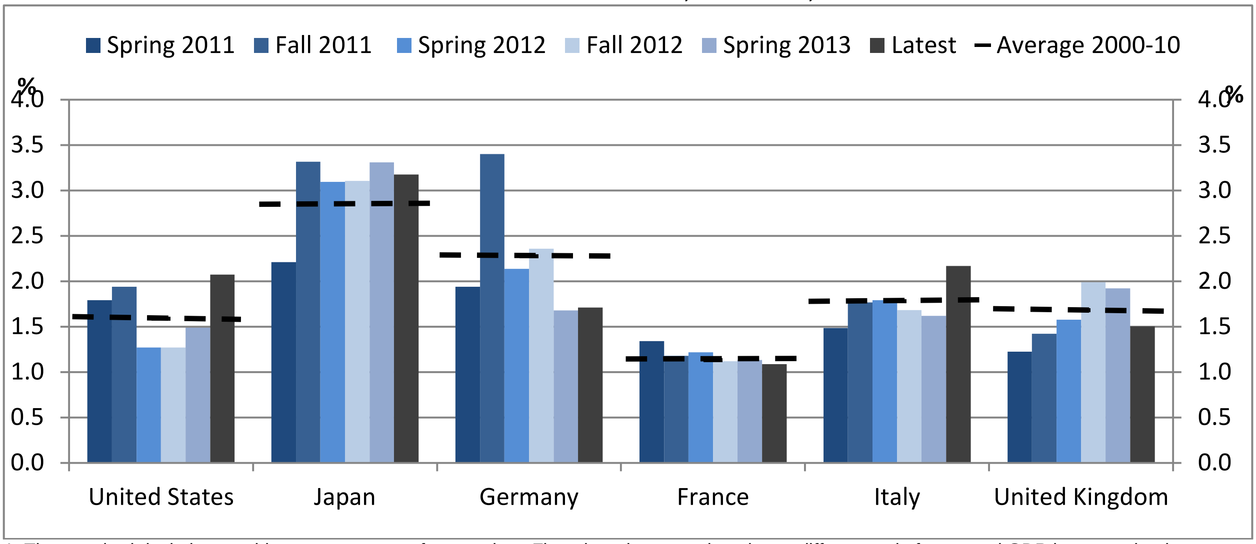
The main tool is a suite of indicator-based models that serve to forecast real GDP for each of the G7 economies.[1] The suite has now been extended to cover China, although this is based on shorter time series and a more limited range of indicators. The models cover the two quarters following the last one for which official data have been published, with the different models receiving equal weights in the computation of the published forecast. They use a small, country-specific selection of monthly indicators, hard (*e.g.* industrial production, retail sales) and/or soft (*e.g.* business confidence). These models have been shown to outperform a range of other models relying solely on published quarterly data, as regards both forecast-error size and directional accuracy. The models used for the US and the UK economies have been modified to better capture the influence of developments in the housing sector, with the inclusion of various forward-looking housing indicators. For China, the published forecast is based on hard indicators only.

Uncertainty around the forecasts

The standard deviation as a measure of uncertainty captures the divergence in GDP forecasts across the soft- , hard- and mixed-indicator models as well as within-model uncertainty, which may for instance reflect imprecisely estimated coefficients. In contrast to standard measures of uncertainty such as root mean squared forecasting error (RMSFE), the standard deviation around the forecasts based on quantile regressions reported in the figure below is contingent on current economic circumstances and may vary significantly over time.[2]

Uncertainty around GDP forecasts

Standard deviation around forecasts, % of GDP, annualised rates[1]



1. The standard deviation combines two sources of uncertainty. First, there is uncertainty due to differences in forecasted GDP between the three models (soft-, hard- and mixed-indicator models) that are used to make the projections. Second, uncertainty around the GDP forecasts of each individual model is derived using quantile regressions, which allow some explanatory variables to have more weight in explaining GDP during a sharp downturn (or recovery) than in more normal times. For technical reasons, this analysis is not report for Canada and China.

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1 See Pain, N. and F. Sédillot, "Indicator models of real GDP growth in the major OECD economies", *OECD Economic Studies*, No. 40, 2005 and Mourougane, A., "Forecasting monthly GDP for Canada", *OECD Economics Department Working Papers*, No. 515, 2006; Chalaux, T. and C. Schwellnus, "Indicator models of real GDP growth in major emerging economies", *OECD Economics Department Working Paper*, forthcoming.

2 Laurent, T. and T. Kozluk (2012), "Measuring GDP Forecast Uncertainty Using Quantile Regressions", *OECD Economics Department Working Papers*, No. 978, 2012.